TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Urban Real Estate Program | ITEM NUMBER: 10

ATTACHMENT(S): 1

ACTION: _____ | DATE OF MEETING: January 5, 2000

INFORMATION: X | PRESENTER(S): Mr. Mitchell

EXECUTIVE SUMMARY

One of the objectives for the Investment Branch was to "create and present a program for urban redevelopment projects in larger metro areas in the United States". The first step in accomplishing this objective was for Pension Consulting Alliance, Inc. (PCA) to make a written presentation at the November 1, 1999, Investment Committee meeting regarding the definition, risks, and merits associated with an Urban Real Estate Program. The term "urban investing" was defined as a wide spectrum of investment activities including development and redevelopment of real estate projects that serve, operate in, and hire from inner city neighborhoods. The expected risks and returns associated with the different investment strategies vary considerably depending on the extent of leverage and financing used. PCA found that the expected risks and returns related to the commercial and retail urban development and redevelopment are consistent with the investment parameters of the CalSTRS' high-risk category in the real estate portfolio.

At the November 1, 1999, Investment Committee meeting staff was directed to develop and present a proposed scope, purpose, and size for an Urban Real Estate Program. A discussion providing background, delivery vehicles, investment strategies, and investment focus has been included as Attachment 1.

The investment focus of a proposed CalSTRS Urban Real Estate Program included the following aspects:

1. Location: West Coast
2. Metro Area: Greater than one million population
3. Type: Development and redevelopment of real estate projects
4. Delivery Vehicle: Commingled fund
5. Strategy: Opportunistic basis
6. Maximum Size: One half of high-risk target based on amount funded
7. Return Expectations: Low-risk real estate return plus 3% to 5%

RECOMMENDATION

Staff recommends Investment Committee approval of an Urban Real Estate Program within the investment focus identified in Attachment 1. All investments made in this program will be contained in the high-risk category of the real estate portfolio. All investments and commitments shall be consistent with the appropriate sections of the CalSTRS real estate policy.

CALSTRS' REAL ESTATE PROGRAM

In accordance with the Investment Management Plan, the California State Teachers' Retirement System (CalSTRS) has established an allocation for a real estate portfolio. The primary purpose of the real estate portfolio, as defined in the 1999 Real Estate Business Plan, is to improve diversification of the overall investment portfolio. Secondary objectives are to achieve a rate of return that corresponds to the amount of risk taken and to provide a stable cash flow. The risk/return composite of the real estate portfolio is divided into three categories: low-risk, moderate-risk, and high-risk. The real estate policy defines the strategic target and tactical range for each component as follows:

	Strategic Target	Tactical Range
Low-risk	50%	40% to 75%
Moderate-risk	25%	10% to 25%
High-risk	25%	10% to 25%

The estimated market value of the CalSTRS real estate portfolio is composed of 80% low-risk, 4% moderate-risk, and 16% high-risk investments. More portfolio detail is provided below in the existing portfolio segment.

Definition of High Risk Real Estate

The CalSTRS' Real Estate policy defines high-risk real estate as:

1. Expected real rate of return higher than 12% (after a 3% inflation assumption)
2. Traditional and non-traditional property types
3. Vacant or construction related (includes development and redevelopment)
4. Moderate to high leverage, between 50% and 90% loan to value
5. Appreciation is the largest component of future value (not cash flow)
6. Geographically concentrated; potentially international locations

It is important to emphasize that the high-risk strategy will not incorporate diversification guidelines by property type or by geographic region.

Delivery Vehicle

With the prospects of a continued period of a controlled rate of inflation, institutional investors have begun to shift their focus on real estate investing from the low-risk category to the moderate-risk and high-risk categories. CalSTRS began investing in high-risk real estate in 1996. As of December 31, 1999, the high-risk real estate category consists of three commingled funds. In the 1999 Real Estate Business Plan and November 1999 PCA report on urban real estate, three alternative delivery vehicles have been identified as appropriate for the high-risk category of CalSTRS' real estate portfolio: Direct Investment, Joint Venture, and Commingled Fund. A recent IFE survey showed pension funds held their real estate assets in direct investments 65%, joint ventures 8%, commingled funds 21%, and REIT securities 7%. For the purpose of the CalSTRS' urban real estate investment report, REIT structured securities were not considered in the evaluation process.

Direct Investment - This delivery vehicle allows the most control to buy, sell, or modify the real estate investment. There is a moderate amount of liquidity depending on the size, location, and property type. The owner has control over the asset management and property management. The cost structure is the most flexible and usually the lowest option relative to the alternative delivery vehicles.

Joint Venture - This delivery vehicle allows limited control to buy, sell, or modify the real estate investment. Usually there are specific partnership contractual terms identifying how, where and when the partners can act. The partnership terms limit the liquidity of the investment. The partnership agreement addresses the control over asset and property management. The cost structure is not flexible, but may be competitive to the alternative delivery vehicles.

Commingled Fund - This delivery vehicle allows no control over the buy, sell, or modification decisions. There is very limited liquidity at a substantial discount to fair value. There is no control over the asset management or property management decision. The cost structure is the highest and least flexible of the alternative delivery vehicles.

Due to staffing limitations the direct investment option will not be considered for some time. However, in the 2000 Real Estate Business Plan, staff plans to present a report identifying possible joint venture investment strategies through its existing real estate managers in moderate-risk and high-risk vehicles. Since the real estate manager would be doubling as the developer, specific contract language would be included to protect both the real estate manager and CalSTRS. By default, the commingled fund is the only delivery vehicle available to CalSTRS until the joint venture option has been reviewed, presented, and approved.

Strategies used by Commingled Funds

In the evaluation of commingled funds, there were four broad types of investment strategies identified:

(A) **Financial engineering**- Financial engineering include the conversion of private entities to public companies, arbitrage of lower rated securities into higher rated product, and use of leverage for the purpose of increasing the shorter-term expected return.

(B) **Development/redevelopment projects** - Development and redevelopment of real estate projects are defined as projects that are dependent on the quality of the real estate

(C) **Operating companies -** Operating companies are defined as entity level investment, which is more dependent on the operating of the entity than the real estate involved. One example would be the purchase and operation of a casino with limited real estate holdings.

(D) **Mortgage & mortgage backed –** Mortgage and mortgage backed activity are defined as fixed income related securities. The value of the security is primarily dependent on the level of interest rates with a secondary consideration of the under lying real estate property.

Current Policy

The Real Estate Policy, approved in May 1999, states that the rejection and approval decision for high-risk properties and commingled funds is delegated to staff with the stipulation that all investments, up to $100 million, are subject to the appropriate due diligence as defined in the real estate procedures. The real estate procedures specify that a dual approval process by staff and an independent fiduciary is necessary for high-risk investments. Also, before approval, a written verification from the real estate consultant for policy compliance must be received.

Existing Portfolio

As identified above, the Real Estate Policy identifies a target of 50% low-risk, 25% moderate-risk, and 25% high-risk. The following chart provides the estimated market value of CalSTRS' real estate portfolio as of 12/31/99. Additional columns are provided showing the targeted amounts by risk category for a $3.1 billion and a $5.0 billion real estate portfolio.

Risk Category	**Estimated Value (in millions)**	**Target Percentage**	**Allocation at $3.1 billion funded**	**Allocation at $5.0 billion funded**
Low	$ 2,529	50 %	$ 1,550	$ 2,500
Moderate	111	25 %	775	1,250
High	488	25 %	775	1,250
Totals	**$ 3,128**	**100%**	**$ 3,100**	**$ 5,000**

Note: Estimated market value of portfolio includes closings scheduled to 12/31/99

The estimated amount for the high-risk category is approximately $300 million under its target, while the moderate-risk category is approximately $650 million under its target. With a substantial number of additional low-risk properties in the real estate pipeline, the percentages in the moderate-risk and high-risk categories are expected to continue to decrease over the coming months.

Focus of CalSTRS' Urban Real Estate Program

To be consistent and conservative, the proposed CalSTRS Urban Real Estate Program is designed to exhibit attributes similar to the limited partnerships contained in CalSTRS' alternative investment portfolio. These attributes include:

1. Alignment of interest between the general partners and limited partners through a relatively sized general partner capital commitment.
2. Targeting the size of CalSTRS' limited partnership commitment to between 10% and 25% of the fund.
3. Requiring the general partners to have previous real estate experience preferably in a similar type of investment activity.
4. Utilizing an independent third party to assist in the review and evaluation of potential investments.

Operating within the attributes described above the investment focus of the CalSTRS Urban Real Estate Program should be as follows:

1. Location – Confine the majority of activity to West Coast locations recognizing that a nationwide program could be implemented after a successful history has been established on the West Coast. Because of geographical proximity, CalSTRS could maintain a higher degree of control over West Coast projects.

2. Metro Area – Target markets would be metro areas with populations greater than one million people.

3. Type – Begin the Urban Real Estate Program with development and redevelopment projects as described above. Additional alternatives could be considered by the CalSTRS Investment Committee at a later date.

4. Delivery Vehicle – Utilize commingled funds for the initial commitments. Later joint ventures, with existing managers, could be used if approved by the CalSTRS Investment Committee.

5. Strategy – Commit to partnerships on an opportunistic basis rather than fixed or structured basis recognizing that investment opportunities vary over time. Each commitment would be given after the staff and independent fiduciary completed their review and analysis.

6. Maximum Size – Establish a maximum size for the Urban Real Estate Program at one half of high-risk category based on amount funded. At the 12/31/99 estimated level of $3.1 billion, the maximum size would be $387 million on a funded basis, which would represent approximately $750 million on a committed basis. No target size is provided because each commitment is expected to be made on an opportunistic basis.

7. Return Expectations – The expected returns for the Urban Real Estate Program are identical to the other high-risk real estate investments, which has been approved as 3% to 5% above the low-risk real estate category.